THE RICHEBÄCHER LETTER

Monthly Analysis of Currencies and Credit Markets

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High Tech Crash

> **"The chief reason for the financial confusion in the late 1920s, as in similar eras of the past, was the credit inflation. Combined with stable price levels, it generated a sense of security and an overestimation of the expansionary potential. This misled a dynamic society into recklessly speculative ventures on an unprecedented scale."**
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> **Melchior Palyi, *The Twilight of Gold*, 1914-1936**
> **Henry Regnery Company, Chicago, 1972**

The U.S. stock market has raced ahead of the U.S. economy in the 1990s. While the S&P 500 and the Dow have more than doubled since 1990, economic growth is at postwar lows. More troubling is the fact that much of the anemic economic growth that has been realized comes from a sector that faces serious prospects of slowing sales and deteriorating profits — high tech.

In this issue we demonstrate how the heady rise in the valuations of stocks and bonds in the 1990s far exceeds the creation of real physical wealth during this period. We also show how the almost exclusive focus by many economists on the CPI in search of signs of inflation dangerously ignores these excesses in the financial markets. These pundits fail to see how the severe overvaluation of financial assets ultimately leads to maladjustments in demand components throughout the economy, which can ultimately lead to a steep disinflationary spiral. Such was the case in Germany in the 1920s, in the U.S. before the Crash of 1929, and in Japan in the early 1990s.

In this letter we again detail the factors that have created the current asset bubble, and note that, in the near term, they will likely continue to inflate the bubble. The inescapable conclusion is that we are entering a phase of increased risk in the stock markets. This is evidenced not only by the pullback in the major markets in March, but more ominously by this year's decimation of high tech shares.

How does the present setback in global stock markets differ from that of last summer? First of all, it has started from a considerably higher valuation level; second, there is a stronger expectation of a rate hike by the Fed. Yet, we think, the decisive difference lies somewhere else: namely, in a growing perception of continuing serious trouble in the high tech area. Technology stocks have already been decimated — but there is a fear that the slaughter may not be over.

The NASDAQ 100 (NDX) and Morgan Stanley High Tech (MSH) have declined 14 percent and 18 percent from their January highs. A growing list of previous technology highflyers have lost half of their value and more (See list on page 11). Largely because of overweighted positions in technology, performance in aggressive growth mutual funds has been abysmal. High profile mutual funds Van Wagoner Emerging Growth, Twentieth Century Vista, PBHG Emerging Growth and Nicholas Applegate Emerging Growth have year-to-date declines of 19 percent, 18 percent, 20 percent, and 14 percent.

Not surprisingly, there is talk of significant redemptions as investors flee these losing funds — redemptions that force additional selling and lead to even poorer performance. While most investors claim they are long-term investors, losses of this size are apt to cause a reassessment.

Even the PC and semiconductor stocks, recent favorites among momentum players, have suffered sharp sell-offs. Belatedly, pundits are focusing on slowing industry demand for computers and mounting overcapacity that have been apparent but largely ignored for many months. Corporate demand for computers, having proved

The bulls' fixed idea is that in Europe, just as in the United States, corporate restructuring and other efficiency exercises will deliver the miraculous profits that justify the miraculous stock prices. Our reservations in this respect are the same as those we have expressed in past letters about the U.S. profit bonanza of the 1990s: it has sprung overwhelmingly from the one-time steep fall in interest rates. This is also the case in Europe. Restructuring has been grossly overestimated as a profit source. Ergo, the big profit gains of the recent past cannot be extrapolated into the future.

High and rising profits are one thing, all-time highs in their valuations by the markets is another. Profits have recovered sharply in Europe, but well behind the market move. The readily comforting explanation is the steep decline in interest rates.

Yes, but from present lows there is little or no room left on the downside. Moreover, what other than rampant leveraged speculation explains the low bonds yields? Is this a virtuous or vicious circle?

Ironically, it may be said that its chronic mass unemployment truly does signify for Europe a New Era — but an era that heralds loose money into eternity. These two conditions (mass unemployment and a booming stock market) existing simultaneously and in contradiction to each other — combine to form the decisive, fundamental change that distinguishes the present from the past. It is an absolutely unprecedented scenario. This is a New Era that hardly deserves the glorification it gets from the booming stock markets.

INFLATION VERSUS SAVINGS AS A SOURCE OF INVESTIBLE FUNDS

What drives the valuations in the markets? Capital value is increased by savings, says Irving Fisher in his Theory of Interest. Today's device is: capital value is increased by financial leveraging.

According to popular perception, the global boom in the financial markets is fueled by a vast excess of liquidity. Yet nobody bothers to think for a moment about the most important issue in this context: What exactly is the origin of these vast masses of money flooding the financial markets? They are simply there — with marvelous wealth effects.

We often think to ourselves that these financial analysts of today know everything about everything, except about the essence of savings and liquidity. In their eyes, inflation begins and ends with the consumer price index. When that index rises, it's bad, but when bond and stock prices jump, it is, by definition, a sign of economic health and the absence of inflation. Little more goes into their heads.

In the same vein, these financial experts lack any theoretical concept of what distinguishes a dangerous bubble from a healthy bull market. We hasten to add that the economists of the old school (both Austrian and Cambridge school) possess such a concept and therefore also a precise answer to this intrinsic question. One of the books, where this point is most clearly expounded is Gottfried Haberler's Prosperity and Depression, first published in 1937.

The answer, in short, lies in a strict distinction between two separate sources of the supply of investible funds: savings from current income versus inflation or nonsavings. In healthy markets, savings are the principal source But, depending on monetary conditions, flows from savings are in varying degrees supplemented by inflationary flows. All money flows from sources other than current savings rank as inflation.

In the bull market of the 1990s, the relationship between the two sources of investible funds has been turned upside-down. The inflationary flows that used to be the supplement, have become the principal, while current savings are now the fractional supplement to torrents of nonsavings.

What, then, are the inflationary sources of investible funds? We identify six such major sources, vastly dwarfing the flows from current savings:

1) central banks;

2) commercial banks;

3) domestic and international carry trade by nonbanks;

4) shifts out of money balances into securities;

5) corporate stock purchases (mergers, acquisitions, stock buybacks);

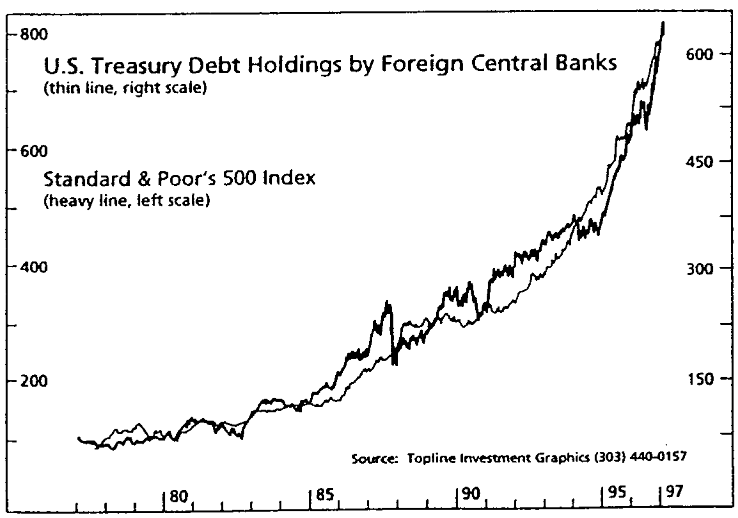
6) capital gains;

7) use of derivative instruments.

Central banks, play a pivotal key role in fueling this frenzied global financial speculation. With their persistent monetary looseness and the associated imposition of extremely low short-term interest rates, some of them have created irresistibly favorable conditions for the financial leveraging that stokes this financial asset bubble. By putting unlimited amounts of yen at 0.5 percent interest at the disposal of international financial speculators, the Bank of Japan is certainly the greatest promoter of this financial mania.

No less decisive in keeping the global financial bubble aloft are the persistent, heavy dollar purchases by the Asian central banks, running in recent years at well over $100 billion annually. Compared to total financial flows, this may seem a fairly small sum, but these official dollar purchases are crucial in shielding the dollar and forestalling the tightening of U.S. monetary policy that is needed for balance-of-payments reasons.

For sure, once these central banks would stop their heavy dollar buying, both the dollar and the U.S. financial system would abruptly be in crisis, forcing the Fed to drastically tighten its reins, which would unquestionably prick the bubble.



Even though the dollar has strengthened against the yen and the European currencies, dollar purchases by these central banks have continued on a massive scale. In the week to March 5, they added another $ 10.3 billion to their Treasury bond holdings.

Stopping these dollar purchases would imply a rise of their currencies, which they are desperate to prevent, so far at least. But could something happen that forces them to stop these purchases or even to sell dollars? Yes, a Mexican-style financial crisis in one or several of these countries would inevitably trigger dollar sales from their reserves. In recent letters, in particular the last one, we have elaborated on the internal and external ills of some of these countries.

Just as in the case of Mexico's 1995-96 crisis, the financial community is habitually blind to such woes. Just a year ago, Thailand still looked among the fiercest of the Asian tigers, with 8.5 percent real GDP growth and a roaring stock market. Its currency was considered undervalued. Today, the central bank is embroiled in a desperate struggle to prevent a banking collapse and a devaluation of its currency. But this requires high interest rates, which tend to aggravate the economic situation.

Since the whole region is in varying degrees plagued with the same troubles, such as property gluts, nonperforming loans, overcapacity, weak yen, and large short-term foreign liabilities, the crisis of one country could easily become contagious. For the time being, the hope that strengthening U.S. demand will bail out the region, is prevailing over deteriorating news.

WHAT MAKES A BUBBLE?

Trying to identify the specific money flows that make a bubble, we have to recapitulate a few basics.

In a balanced economy and financial system, the funds available for the purchase of real and financial assets are limited by available current gross savings, which consist of business deprecations, retained business profits and personal savings from current income.

If we assume that businesses largely invest their deprecations and retained profits internally, this leaves personal savings as the main source of new investible funds. (Personal savings, by the way, include all contributions to pension funds from current profits and income.) In the United States, personal savings currently amount to about $260 billion annually. But actual flows into the financial markets are many times that amount. Last year, U.S. equity mutual funds alone attracted the enormous sum of $223 billion.

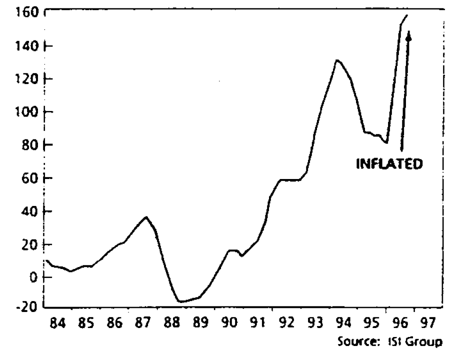
Where, then, does all the nonsavings money that has been pouring into the market come from? In short, from the seven different sources that we have listed above. In the past, the two main sources of money inflation were bank credit and reductions in money balances. But financial deregulation and globalization have created unprecedented facilities to mobilize virtually infinite amounts of money for the purchase of securities.

For the global bond markets, the most important of the seven channels listed above is without question the carry trade, and within this category, the yen carry trade. Borrowing yen to finance heavily leveraged holdings of high-yielding bonds of different currencies is of course the favorite ploy because of the yen's ultra-low short-term interest rate. But it is practiced in all currencies with low short-term rates. Presumably, the boom in Europe's high yielders rests heavily on carry trade, financed with Swiss francs and DM.

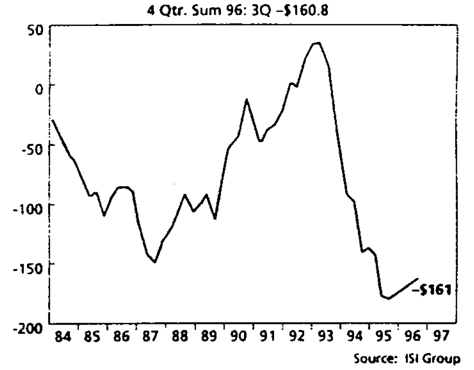
There are no statistics that allow a reasonable estimate of the existing carry trade, domestic and global, as it takes place

Equity Fund Sales Inflated

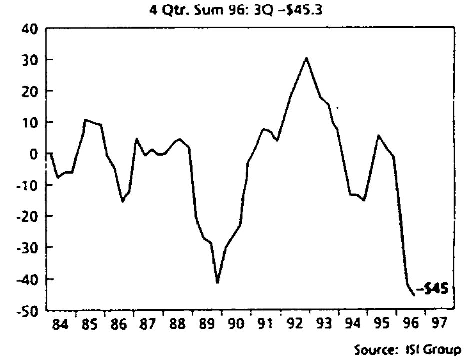
Household Purchase of Equity Mutual Funds
4 Qtr. Sum 96: 3Q $159.9



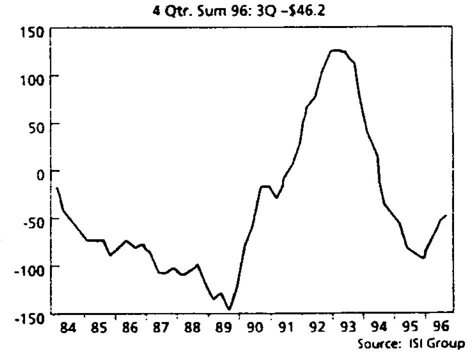
Household Direct Purchase of Equities
4 Qtr. Sum 96: 3Q -$160.8



Pension Fund Purchase of Equities
4 Qtr. Sum 96: 3Q -$45.3



Household Direct + Mutual Fund + Pension Fund Purchases of Equities
4 Qtr. Sum 96: 3Q -$46.2



mostly through Eurobanks across borders and also among nonbanks. Therefore, it does not show in national credit or money figures. Still, it's a fair guess that altogether this speculative bubble must be running into very many hundred billion dollars. For various reasons, the present carry trade bubble is a lot bigger than that of 1993.

All in all, we draw two conclusions: first, carry trade speculation has been a major downward influence on global bond yields, implying vulnerable markets; and, second, the greatest foreseeable danger — but still many months away — is any monetary tightening by the Bank of Japan.

As to the U.S. stock market, we see three main bullish influences: first, the futures markets; second, corporate stock buybacks; and third, mergers and acquisitions. In other words, it's fueled by leveraged speculation and corporate buying.

According to market lore, the chief bulls in the U.S. stock market are private households flooding it through mutual funds. As we have repeatedly pointed out, this story is grossly at variance with the Federal Reserve's flow of funds statistics. In addition, the flows of funds into equity mutual funds are heavily distorted by two shifts:

1) individuals have been dramatically reducing their holdings of equities in favor of equity mutual funds; and 2) individuals have seen a dramatic shift in their retirement provisions from pension entitlements to 401(k) investment plans, which typically move from pension funds into some mutual funds.

The Fed's Flow of Funds figures — when added together for mutual funds, direct stock holdings and pension funds — show that in 1996 mutual fund inflows were more than offset by the other two shifts, i.e., that private households were net sellers of equities. As usual, when the actual figures don't jibe with the bull story, they are discarded as flawed. We have a preference for facts and figures.

Still, we wouldn't interpret this net selling of stocks by private households as bearish. The selling by households is largely involuntary, and essentially reflects a net withdrawal of stock by corporations. Since 1994, soaring new issues are more than offset by even bigger corporate repurchases. Last year, stock buybacks hit a new record of $176 billion. At the time, there were mergers and acquisitions worth more than $ 650 billion, following 1995's $450 billion in M&As. Nor is there a letup this year.

Only a small percentage of these deals, though, is done with cash because a cash purchase would force the buyer to lower his earnings by having to deduct "goodwill" as a result of the fact that he paid more than book value. Stock-to-stock transactions use an accounting technique that avoids these charges and makes earnings look better. Though largely cosmetic, this device pleases Wall Street.

But even though this merger mania involves little cash, we think it contributes importantly to the bullish spirit in the market. In general, these mergers do nothing for the economy as a whole, but in the view of the investors they hold the promise of improving profits by cost cutting.

UNDERSTANDING 1929

In a recent Wall Street Journal article, entitled "Understanding 1929", Mr. Wayne Angell has taken Mr. Alan Greenspan to task for having dared to deliver a full-fledged, damning critique of Wall Street's rising tide of frenzied financial speculation. He specifically referred to the warning of Mr. Greenspan that "participants in financial markets are susceptible to waves of optimism", which can feed through asset price inflation to the markets for goods and services. And Mr. Angell criticizes Mr. Greenspan for his belief that stock market excesses can act to amplify any downturn in economic activity.

At issue is the famous quiz: What caused the U.S. stock market's collapse in 1929-30 and the following Depression? The one view is that both events were essentially the result of the prior stock market excesses. The other principal view, however, is that they were due to a misguided monetary policy that became too tight when the market turned down.

The latter is, of course, the brain child of Milton Friedman and the American monetarists. Mr. Angell scornfully discards the view that the bust was due to a speculative boom and calls this view "decidedly Keynesian, with its Marxist business cycle roots". Obviously, Mr. Angell needs some lessons in economic history. The fact is that Keynes, like most American economists today, completely failed to see and to understand the intricacies of the stock market bubble. Looking for signs of inflation, he focused exclusively on commodity and consumer prices, which were stable. By the way, Keynes went nearly bankrupt as a result of the crash.

The one and only economic school, but not mentioned by Mr. Angell, that had truly developed a kind of boom-and-bust bubble theory, was the Austrian school. For them, the essence of inflation is not in the conventional price indices but in the credit excesses of the boom that overexpand certain demand components, thereby causing economic distortions and maladjustments.

WHAT IS WRONG WITH AN ASSET BUBBLE?

Yes, what is wrong with soaring asset prices? In contrast to rising prices of goods and services, they don't hurt anybody. Just the opposite, don't they create wealth? Wall Street and the like make us rich, don't they?

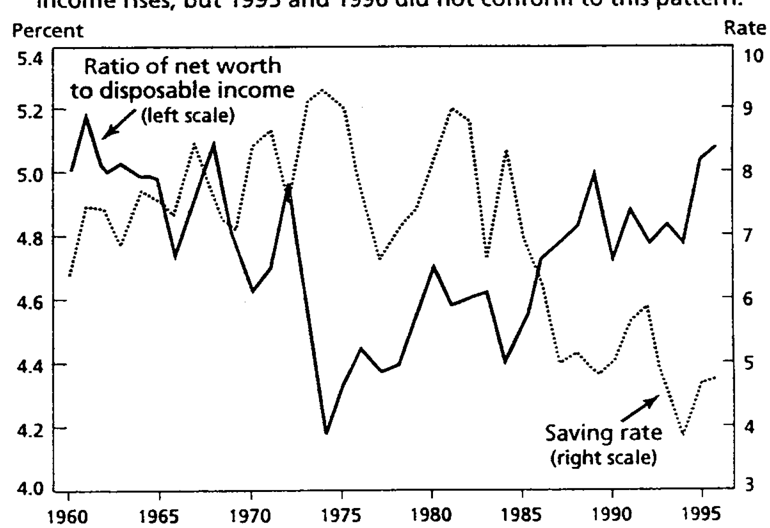
Now, the first and most important thing to see is that soaring asset prices don't create wealth. The apparent wealth creation of recent years in the financial markets is mere paper wealth that adds almost nothing to the material wealth of the world. While real wealth creation in the shape of real capital goods, which alone increases national wealth, has shrunk to a trickle, paper wealth expands in profusion from two main sources. The one is soaring stock valuations and the other one is soaring debt creation for purposes other than real investment.

As we have explained in earlier letters, today's debt creation — translating into the booming wealth of the investors — overwhelmingly springs from the booming capitalization of compounding, unpaid interest on unproductive debt. Even corporations no longer borrow to invest, but rather to finance transactions such as acquisitions, mergers, and stock repurchases. Nothing of this creates value. Some old economists called it imaginary capital. We prefer to speak of phony capital.

The salient thing to see is that this financial wealth creation has completely decoupled from the economy proper and the limits of current savings and real investments. In the Economic Report of the President, 1997, we found a chart highlighting the sweeping disjunction in

Wealth and Saving

The saving rate tends to fall when the ratio of net worth to income rises, but 1995 and 1996 did not conform to this pattern.



Note: Data for 1996 are for third quarter; household and net worth estimated by Council of Economic Advisors.

Sources: Department of Commerce & Board of Government at the Federal Reserve System.

the United States between exploding financial wealth and shriveling savings. Of course, the authors saw in this no problem.

Mr. Angell and other protagonists of the virtues of a bubble also fail to see or to understand that the price excesses in the assets markets unfortunately do not occur in splendid isolation. Rather, price excesses in financial assets essentially transmit impulses to the economy, invariably distorting demand and output structures and leading to a misallocation of resources.

In Japan's famous case of the late 1980s the bubble went with a vengeance into excessive investment in and development of real estate, and the overexpansion of industrial capacity. When the bubble burst, it proved the biggest malinvestment boom in history, from which the Japanese economy is still struggling to recover.

We have identified the U.S. financial boom as a bubble fueled by unfettered nonsavings (inflation) flows. But where are the disruptive effects on the economy that regularly go with a bubble? To come to the point: they are in the unsustainable consumer borrowing binge.

The irony is that many American economists even hail the connection between the consumer borrowing binge and the booming financial markets as a great positive, arguing that the wealth effects (alias bubble effects) offset the debt increase and thus allow its infinite continuation. For disciples of the Austrian school, it is a hair-raising concept to link debt-financed consumer spending benignly with a booming stock market. In their view, it was just that combination that brought on the Depression of the 1930s.

Distortions and maladjustments in the economy are one big ill effect of a bubble economy. The other one is the progressive erosion of liquidity. While the roaring markets give the impression of overabundant liquidity, they reflect in reality exactly the opposite: a mass flight out of liquidity associated with massive leveraging and credit pyramiding for financial speculation.

THE SOURCES OF THE BOOM

Back to out starting point: What are the effective sources of the torrents of money that are flooding the financial market — savings versus inflation or nonsavings? The following quotation from *National Economic Trends* (December 1996) of the Federal Reserve Bank of St. Louis is probably typical of the thinking of American economists: "The purchase of stocks is a form of saving, and constitutes a decision by households to defer consumption in order to, hopefully, be able to consume more in the future than they otherwise could." Just imagine, Mr. Soros and his friends are buying stocks from their current savings.

As a matter of fact, even small personal investors can and actually do buy bonds and stocks far in excess of their current savings. Either they borrow or reduce their money balances. In our view, the latter plays an enormous role among individual investors. It's the "cash is trash" syndrome. Given the steep yield curves and the booming stock markets, there has developed a self-feeding global stampede out of the existing immense money balances and into stocks and bonds that is completely independent of the current savings or the current growth in the money supply.

This process is well-known in monetary theory, except to monetarists. Keynes would have called it collapsing liquidity preference. Other terms are "dishoarding", flight from money, collapsing demand for money. For the old economists, any flight from money was highly suspect as the typical phenomenon of runaway inflation, reflecting a general effort to reduce money holdings. Most of the German runaway inflation in the early 1920s came from such a flight from cash, rather than from credit creation.

For us, the parallel to the present asset inflation is evident. The only difference is that in the 1920s the

money in Germany fled into goods, while today it flees into stocks and bonds. Principally, it's the exact same process. Then, it was the expectation of rising goods prices that fueled the flight from money; today it is the expectation of rising bond and stock prices.

All this leaves us with the pertinent question, how much longer can this state of nirvana for financial speculators last? The one obvious essential condition for the current bubble to persist is continued global monetary looseness and the willingness of the central banks to tolerate unfettered speculation. In this light, the one feasible threat is the prospect of strengthening economies with rising inflation, which would compel major central banks to substantial monetary tightening.

In this respect, we can only repeat our long-standing opinion that the world economy is in for a lot more sluggish growth with low inflation. The one surprise that we considered possible in 1997 is not a strengthening of the European economies but a weakening U.S. economy.

THE NEW ERA — LOOSE MONEY FOREVER

Wall Street likes to emphasize the unprecedented global decline in inflation and interest rates as the crucial underlying cause of the booming financial markets, ascribing it to the superb management of today's central bankers. The less palatable truth is that this inflation performance has a deeper cause that is anything but admirable — persistent subpar economic growth.

Where Wall Street hails economic and financial miracles, we see a number of extremely negative trends in all of the economies of the industrial nations:

1) Multiple economic and financial maladjustments have undermined the business cycle and economic growth. The former norm was brisk economic growth associated with strong cyclical fluctuations and pronounced changes in monetary stance. Today's norm is sluggish long-term growth coinciding with weak up and down cycles, keeping monetary policy loose in permanence.
2) Credit and money flows have drastically shifted away from deployment in national products and towards the creation and trading of securities. There is a virtual disjunction between high-flying financial wealth and poorly performing real economic activity.
3) The root cause of this disjunction is a dramatic change in wealth creation. The creation of wealth consisting of net additions to the existing real capital stock has become minimal, while financial or paper wealth — unrelated to any physical assets — expands in profusion.

All three features are without parallel in economic history, and so is their consequence: prolonged, global persistence of monetary looseness. In the last analysis, this financial mania owes its existence to broken economic growth and subdued business cycles warranting lasting low inflation and loose money, on the one hand, and unfettered money and credit creation within the global financial system, on the other. All together, this definitely qualifies as a New Era. For Wall Street and the like, it is nirvana — but for nobody else.

U.S. STATISTICAL FOG

Everybody speaks of the extraordinary strength of the U.S. economy, except us. Just to put things in proper perspective: The U.S. economy's annual rate of real growth has averaged a mere 1.2 percent in the 1990s to date. This is by far the poorest showing in the whole postwar period, comparing with 2.8 percent in the 1980s, 3.2 percent in the 1970s and 4.4 percent in the 1960s. It is, in fact, shockingly low. As an aside, real

consumption grew in the 1990s almost twice as fast as output, at an average annual rate of 2.2 percent. The difference between output and consumption has, of course, been met by the soaring trade gap.

There is some talk that U.S. economic growth, owing to measuring errors in the GDP calculations, is for the last two years considerably understated. Actually, economic growth can be measured by adding up either all the output produced (GDP) or all the income generated in producing that output (GDI).

In theory the two measures should yield the same result, but in practice they may differ owing to measurement errors. The difference is called statistical discrepancy. Over the last two years, measured real GDI grew much faster than GDP: 3.1 percent verses 2.1 percent. That is an unprecedented discrepancy.

The major problem on the output side is the measurement of service consumption, where 30 percent of reported output is based on estimates until the usual later benchmark revision. And it may get worse, owing — we quote the latest Economic Report of the President — to the rapid growth of casino gambling, cellular telephone service, and on-line services. Yes, casino gambling also adds to GDP, and so do the frantic trading of bonds and stocks and opulent Wall Street bonuses.

Will the U.S. economy slow or accelerate in 1997? Though we still feel confident of distinctly slower growth in the course of the year, readings have recently been more on the strong side, especially employment and consumer spending. Yet we observe weakness in most demand components: consumer credit, business capital spending, residential building, government spending, and foreign trade. In correlation, we have forewarned of serious profit disappointments.

The chief upside surprise has been in consumer spending, largely due to the fact that the sluggishness in retail sales was more than offset by strong rises in services, as specified above. A sure major negative influence on the economy will be the trade balance. Last fall's stunning increase in net exports was grossly out of line with fundamental export and import trends, suggesting a strong widening of the trade gap this year. While the trade figures added more than two percentage points to fourth quarter GDP, they may well shave that off again in the first quarter.

A LOPSIDED INVESTMENT SPREE

Investment in equipment by businesses is the other GDP component on which our attention is focused. It was one of the big positive surprises of 1996, accounting for a staggering 31 percent of last year's U.S. GDP growth. Are U.S. businesses, as Wall Street lore has it, on a lasting investment spree in the wake of their restructuring efforts?

Well, the fact is that equipment outlay, after a rapid spurt in 1994, has since been sharply decelerating. Its growth rate has steadily slowed from 14.1 percent in 1994 to 10.6 percent in 1995 and 7.0 percent in 1996. Scrutinizing the figures, we made another highly interesting observation: computers, computers, computers. Last year, the growth in real equipment spending totaled $43.8 billion, of which $40.9 billion, or 93 percent, was in computers. Spending on all other equipment, such as industrial machinery, machine tools, and transportation equipment, is basically flat over the last two years.

Here is another calculation that keeps one wondering about the robustness and broadness of the U.S. economic recovery. Over the twelve months to October 1996, industrial production rose overall by 3.8 percent. Half of this increase came from computer output. Having accounted for a mere 1.8 percent of total manufacturing output in 1992, its output skyrocketed by 50 percent in the course of 1996. That is, its contribution to aggregate output growth was almost equal to the contribution to growth of the other 98.2 percent of the economy. Business Week estimates that the U.S. economy ex computers grew a lackluster 1.5 percent last year, which is extremely sluggish.

TECHNOLOGY'S ERSTWHILE HIGH FLYERS

	HIGH JAN	HIGH 6 MONTHS	CURRENT	% CHANGE JAN HI	% CHANGE 6 MNTH HI
3COM	77.375	81.375	32.25	-58.32%	-60.37%
SYNOPSYS	46.25	50	29.375	-36.49%	-41.25%
CLARIFY	52.75	59.25	23.375	-55.69%	-60.55%
RATIONAL SOFTWARE	40.875	41.25	18.625	-54.43%	-54.85%
NETSCAPE COMMUNICATIONS	59.25	65	27.75	-53.16%	-57.31%
FORE SYSTEMS	36	43.625	21.375	-40.63%	-51.00%
CASCADE COMMUNICATIONS	66.625	91.25	24.375	-63.41%	-73.29%
SHIVA	36.75	63.5	12.625	-65.65%	-80.12%
VIASOFT	65.25	65.25	28.125	-56.90%	-56.90%
CITRIX SYSTEMS	51.5	56.75	13.5	-73.79%	-76.21%
GLENAYRE TECHNOLOGY	23.125	27.75	11.625	-49.73%	-58.11%
PAIRGAIN TECHNOLOGIES	43.25	43.25	23.25	-46.24%	-46.24%
FORTE SOFTWARE	38.25	47	21.875	-42.51%	-53.46%
ASCEND COMMUNICATIONS	80.25	80.25	45.75	-42.99%	-42.99%
XYLAN	37.25	59.375	18	-51.68%	-69.68%
VANSTAR	25	29.75	8	-68.00%	-73.11%
INTEL	165	165	133.375	-19.17%	-19.17%
CISCO	75.75	75.75	50	-33.99%	-33.99%
ATMEL	48.875	48.875	23.875	-51.15%	-51.15%

There is yet another aspect of the fictitious nature of the U.S.'s robust economic growth. It concerns the big difference between real and nominal investment spending, owing to the steep decline in high tech prices. Last year, business spending on computers increased by 50 percent in real terms but by 25 percent in nominal terms. In other words., half of the spending never happened.

Like everybody else, we are in awe of high tech and its exponential growth. But we suspect that in the United States there is something like a computer mania that is grossly in excess of what the economic body can efficiently absorb. Above all, we look in vain for any visible fruits in U.S. productivity growth, which in recent years has been at its lowest ever in the postwar period.

We noted with great interest that the Bank Credit analysts, too, has spotted the disproportionate role of computers in U.S. economic growth. They broke the U.S. economy into two sectors: high tech and the rest. Into the former they put investment spending and net trade in information processing equipment and aircraft, some defense investment and consumer spending on computers.

These account for about 5.5 percent of real GDP, but have provided almost 40 percent of GDP growth over the past two years.

High-tech components of the economy have been growing at a 25 percent pace, while their prices have been falling at a 10 percent rate. On the other hand, the remainder of the economy has been expanding at a modest 1.5 percent rate, which is extremely sluggish by the standards of the past.

From this observation, the Bank Credit Analysts draws two highly optimistic conclusions: First, that there is little serious inflationary risk, since the fast-growing sector has falling prices, while elsewhere inflation is held

down by weak demand; second, that in the fast-growing sector something significant is happening — a surge of innovation and knowledge creation which justifies long-term optimism.

Considering the explosive rise in computer output and demand in the United States, we struggle in particular with one question: How long can this continue at its exponential pace? Not to forget, any slowdown will cause trouble. The belief is that a persistent high rate of technological advancements will prevent any market saturation by rendering the installed computer base obsolete in a three- to four-year time frame, which will then conveniently generate high replacement sales.

CONCLUSIONS

Deregulation, globalization and computerization have deprived central banks of any control of global money and credit creation, which is running amuck. Because the economies respond sluggishly, the excess money pours, instead, into the financial markets with a vengeance fueling booming markets rather than recovering economies.

This environment that has underpinned the powerful global equity bull market shows little sign of coming to an early end. Yet sharply increased volatility and divergence in stock prices warn that stock markets have entered a more risky phase.

Capital and money flows to the developing countries, also notorious for contributing to the global monetary looseness, increased last year a huge 20 percent to a record $285 billion. Guess what the main source of this money was: savings or money creation?

The bloodbath in technology stocks is of critical importance for the U.S. economy as well as the stock market. High tech was the prime mover both in this business cycle as in the stock market boom. High tech stocks got hammered not so much because of Mr. Greenspan's warnings of a pre-emptive rate hike but because of troubling signs of sharply slowing sales and deteriorating profits. As we have explained in recent letters, there is, in fact, reason for serious concern in this respect.

As to the Fed, we see only a one-off move, not a succession of rate rises. Economic growth may quite soon surprise on the downside. There are two big potential trouble spots: the widening trade balance and slowing high tech spending.

Even though Mr. Greenspan has lately been talking tough, his action remains extremely liberal. Excess reserves are ample, and broad money growth is spurting. M3 has accelerated to over nine percent and M2 to over six percent, both at annual rates. But it could well be that this sharp uptrend in money growth also reflects a rising liquidity preference of the public.

We are wary of the consensus forecasts of a strong dollar for two reasons: first, continuous monetary looseness is more important than any miniscule rate hike; second, we see a weakening, not a strengthening U.S. economy.

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